Spring 5-2006

Stock Options as Compensation: Good,Bad or Indifferent?

William Henry Kittrell
University of Tennessee-Knoxville

Stock Options as Compensation: Good, Bad, or Indifferent?

Will Kittrell

May 2, 2006

Senior Honors Project

Stock options have recently been the subject of a heated debate within the accounting and business community. The primary issue has been whether or not companies should expense stock options that are used to compensate employees. After the first quarter of 2006, the Financial Accounting Standards Board (FASB) is requiring companies to begin reporting as expenses all stock options that are used as compensation, just as if the options had been any other form of employee compensation. The ramifications of this change could be far-reaching and could drastically affect the bottom line of many companies' income statements. In this essay, I will attempt to provide information that will enlighten the average person as to what exactly stock options are and how they operate. From there I will attempt to determine if the decision by FASB was the correct move for dealing with stock options.

Stock options are a specific "type of option that uses the stock itself as an underlying instrument to determine the options value" ("Stock option"). In employee compensation packages, the option works like a contract to buy shares of stock in the future for a set amount of money, regardless of the stocks actual price at the time of the purchase. For example, assume that you were given stock options by your employer that gave you the right to purchase 1,000 shares of stock at a cost of $30 (the strike price) per share at some time in the future. If the actual stock price was $20 at the time you were given the options, then you would wait for the stock price to rise to the point that it would be profitable for you to purchase them at the strike price. If the stock rose to $40 dollars over the next five years, then you could execute your options and purchase the stock at $30 per share. Then you would own stock worth $40,000 ($40/share x 1,000 shares) even though you paid only $30,000 ($30/share x 1,000 shares) for that stock, which results in a gain of $10,000. This gain could increase very quickly if there was a large gain in stock price and if a lot of shares (100,000 shares, for instance) were promised in the compensation package ("Stock option").

Although stock options sound like a great idea when simply defined, they have proven to be a lot of trouble when used in the real world. Over the last decade, scandals and frauds have been abundant and many of these problems were directly or indirectly related to the use of stock options. Unfortunately, many individual investors have been devastated and many innocent employees have lost their jobs because of these problems. From Enron to WorldCom, these failures have caused people to reevaluate the way that accounting is practiced within these corporations. The larger issues, such as financial statement mismanagement and a lack of independence in the accounting community, were primarily dealt with through the Sarbanes-Oxley Act. However, the use of stock options as compensation by corporations and the financial statement representation of these transactions were left on the table for some time. It was only in the last couple of years that serious efforts to change the way that stock options were treated when used as compensation. Stiff opposition met these efforts and even though the changes have been made, the debate rages on.

There are two primary conflicts regarding stock options when used as compensation. The first involves the motivational effectiveness of these types of wages as opposed to cash. Those who support the use of stock options argue that this type of compensation aligns the employees' interests with the company's interests, particularly with the long-term interests of the company. This is because the proponents of stock options believe that the employees will have an incentive to help the company do well, because when the company does well, the stock will do well and when the stock does well, the employees will make money. One study, which was conducted by Mark Bauman, reiterates the fact that executive compensation packages often "include stock options in order to better align the interests of managers and outside shareholders" (Bauman).

Those who argue against the use of stock options concede that the high ranking officials in the company (CEO, CFO, etc.) will have added incentive to raise the stock price, but they argue that it does not necessarily follow that they will have added incentive to help the company do well in the long-term. The conclusions of the study mentioned above show that regardless of the proposed purpose of the stock option plans, "the use of stock-based compensation intensifies top executives' focus on financial analysts' short-term earnings forecasts" (Bauman). This focus can be counterproductive. Instead of focusing on positioning the company for success in the future, top executives may simply try to make the company look as good as possible in the short-term. Indeed, stock options essentially create a conflict of interest for the top executives. By using underhanded accounting methods and faulty presentations of the actual condition of the company, the executives in a firm may cause the stock price to rise significantly. They can then execute their options before the market realizes the actual condition of the company and thereby the executives can make millions of dollars (some executives have made stock gains in excess of $100,000,000) – all at the expense of average investors ("Executive Pay").

The second conflict deals with the accounting practices that are used in dealing with stock option compensation packages. Before the changes that FASB recently made, "options were invisible on the corporate income statement. No matter how many a company handed out, they could tell investors that they cost nothing" (Gimein). Many argue that options should be reported as a compensation expense just as cash compensation would be reported. Being able to pay your employees without actually incurring any costs to yourself for that payment seems too good to be true, they argue. It also leaves investors with an incomplete picture of companies' financial situations.

Those who argue against expensing stock options say that investors will not value the information provided by the new reporting requirements. As it turns out, this argument may be a valid one. Indeed, one article in <u>The Wall Street Journal</u> that was written shortly after companies began to report options compensation as an expense is titled "Wall Street turns Blind Eye to Results of Option Expensing" (Gullapalli). Another argument is that many companies will be hurt financially by such changes and that small companies will not be able to get off the ground without stock options packages that are "off the books." Those opposed to expensing options also say that "CEOs might well lose little or nothing" as a result of the changes proposed and recently implemented by FASB (Gimein). They argue that excessive compensation for CEOs and other top executives is the primary concern of most proponents of stock option expensing, and that this cannot be solved simply by forcing companies to expense stock options. They argue that the problem is not in the stock option plans, but in the accounting controls that allow executives to "fudge" the numbers. According to critics, the Sarbanes-Oxley Act was enough to clear up these problems and since these issues have been addressed, stock options can now be used without significantly increasing the risk of fraudulent activities.

What will the end result of this conflict be? As of right now, it looks like the expensing of stock options is here to stay. The effects of these changes are far less certain. Hopefully, the effects will be in line with FASB's goals. Based on my understanding of the situation, the goals of the FASB's new accounting standard has two parts: to guard against exorbitant executive compensation packages and to ensure that companies are being accurately portrayed to the public in order to guard the assets of current and potential investors. One likely effect of these accounting changes is that there won't be as many stock options in compensation plans anymore, since one of the main incentives for using them (benefits for the employees with no effect on the bottom line) is gone. Many companies have already been phasing out many of their stock option plans in order to prepare for the pending changes. Companies have also been phasing in some of the stock options compensation packages into their income statements in order to lessen the impact of the predicted 3% reduction in earnings aggregately (Henry). Fortunately, because many companies have made such adjustments, it appears that the impact of the accounting changes on companies' actual net income is probably not going to be as catastrophic as originally thought by critics of the FASB proposal.

In conclusion, I think that FASB has made the correct decision on this issue. It is encouraging to see that the people who are responsible for the accounting practices of U.S. firms take their responsibilities seriously. Only time can tell what the long-term effect of this decision will be but if we pay close attention now, we may be able to avoid more serious problems in the future. Accountants should always be reevaluating their practices and developing new techniques and standards to protect investors and to thwart those who try to use "gray" accounting procedures to benefit themselves at great loss to others. Hopefully, we can learn from the mistakes of the past and implement changes that will safeguard the investors of the future.

Works Cited Page

Bauman, Mark. "Stock Option Compensation and the Likelihood of Meeting Analysts' Quarterly Earnings Targets." Rev. Quant Financial Accounting (2006) 26: 301-319.

"Executive Pay: Reuben Mark." Forbes.com: 2004. <http://www.forbes.com/static/execpay2004/LIR27R3.html>.

Gimein, Mark. "The Bottom Line on Options." Business Week 4/3/2006.

Gullapalli, Diya. "Tracking the Numbers/Outside Audit: Wall Street Turns Blind Eye to Results of Option Expensing." The Wall Street Journal 07/12/2005.

Henry, David. "Accounting Reform: Earnings: It's Still Apples and Oranges." Business Week 4/3/2006.

"Stock Option." Wikipedia <http://en.wikipedia.org/wiki/Stock_option>.